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In the Supreme Court of the United States

OCTOBER TERM, 1978

HANOVER INSURANCE COMPANY, SUCCESSOR IN INTEREST TO: MASSACHUSETTS BONDING AND INSURANCE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinions of the Tax Court (Pet. App. E, A42-A52); (Pet. App. C, A20-A40) are respectively reported at 65 T.C. 715 and 69 T.C. 260. The opinion of the court of appeals (Pet. App. A, A1-A18) is reported at 598 F. 2d 1211.

JURISDICTION

The judgment of the court of appeals was entered on May 8, 1979 (Pet. App. B, A19). The petition for a writ of certiorari was filed on July 27, 1979. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the Commissioner properly reduced petitioner's claimed deduction for estimated unpaid losses on the ground that it was excessive.

2. Whether the Commissioner's determination that petitioner's claimed estimated unpaid losses were excessive was consistent with Treasury Regulations on Income Tax, Section 1.832-1(b).

3. Whether the decision below correctly upheld the validity of Section 1.832-1(b) of the Regulations.

STATUTES AND REGULATIONS INVOLVED

Sections 832(a), (b)(1)(A)(5) and (c)(4) of the Internal Revenue Code of 1954 (26 U.S.C.), and Treasury Regulations on Income Tax, Section 1.832-1(b) (26 C.F.R.), are set forth in the Appendix, *infra*, 1a-2a.

STATEMENT

During the years in question, petitioner[1] was a casualty insurance company taxed under Sections 831 and 832 of the Internal Revenue Code of 1954. Pursuant to Section 832, petitioner was eligible for a deduction for "losses incurred," which is defined as losses paid, adjusted for salvage and reinsurance, plus unpaid losses outstanding at the end of the current year and minus unpaid losses outstanding at the end of the previous year. See Section 832(b)(5). It is the computation of petitioner's unpaid loss deduction which is at issue in this case.

The unpaid losses component is the total amount of losses which have been incurred by a casualty insurance

[1]The taxes involved in this case are those of the Massachusetts Bonding and Insurance Company for 1959, 1960, and the first half of 1961. On June 30, 1961, Massachusetts Bonding and Insurance Company was merged into petitioner Hanover Insurance Company.

company but which remain unpaid at the end of the year. This estimate includes losses incurred but not yet reported. Like all estimates, the estimate for unpaid losses is an approximation of the actual amount of unpaid losses. Indeed, casualty insurance actuaries do not agree on any one method for the calculation of such "reserves" or estimated future expenditures. A number of methods may be used to calculate the reserve, each of which will yield a different figure (Pet. App. A, A28).

Petitioner used a combination of methods in computing its loss deduction. For reported losses, it used the individual case method, under which each reported loss is estimated in accordance with its own facts. For losses incurred but not yet reported, petitioner used a formula calculation, estimating such losses as a percentage of premiums. It also used formulas to calculate unpaid loss reserves for business done through insurance pools and for miscellaneous other claims (Pet. App. C, A23-A25).

On audit, the Commissioner of Internal Revenue partially disallowed petitioner's claimed loss deduction on the ground that it had overestimated its unpaid losses. The Commissioner made this adjustment after his examination revealed a consistent pattern of overestimation of unpaid losses on certain lines of business from 1959-1961, as reported on Schedule O of the form approved by the National Association of Insurance Commissioners (NAIC) (R. 593-603, 628-630).[2] The examination comparing petitioner's past estimates of

[2]Lines of insurance carried on Schedule O of the NAIC Annual Report deal with injuries to property. Those lines of insurance (such as workmen's compensation or automotive bodily injury coverage) which include injuries of persons are accounted for on Schedule P of the annual report (Pet. App. C, A25-A26). "R." refers to the record appendix filed in the court of appeals.

Schedule P losses with actually developed losses over the five subsequent years likewise showed that certain of those estimates of unpaid losses were also excessive (R. 631). After state insurance audits in 1956 and 1959, the NAIC had called the overestimate of unpaid losses to petitioner's attention, but petitioner took no steps to correct its accounts (Pet. App. C, A27).

The Commissioner accordingly disallowed portions of petitioner's claimed unpaid loss estimates for 1959-1961 on a line-by-line basis.[3] The procedure utilized was as follows: For each line of insurance, the Commissioner determined an "experience rate" based on a ratio of claimed unpaid losses to developed losses. In lines where the claimed unpaid losses exceeded 115 percent of the developed losses the Commissioner applied the "experience rate" to the claimed unpaid losses in the tax years at issue. In this manner, the Commissioner determined an unpaid loss figure based solely on experience. Petitioner's claimed unpaid losses were partially disallowed only to the extent that they exceeded 115 percent of the unpaid loss figure indicated by the experience rate.[4] Put another way, the Commissioner allowed petitioner a 15-percent tolerance, above its historical experience (Pet. App. C, A25-A27).

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[3]For Schedule P losses, the claimed estimate of unpaid losses is compared with subsequent actual developed losses over a five-year period. Schedule P lines of business, representing personal injury claims, require a development of longer than one year before accurate actual losses can be determined. Only years for which a full five-year development was available were used in this comparison. Thus, for 1960, petitioner's claimed unpaid losses for 1951-1955 were evaluated (see R. 66-70).

[4]The Commissioner's expert witness, actuary David Skurnick, testified that the estimates of unpaid losses were overstated (Pet. App. C, A27-A28).

In this suit brought by petitioner for redetermination of the deficiency, the Tax Court upheld the Commissioner (Pet. App. C, A20-A40). The court of appeals affirmed (Pet. App. A, A1-A18).

ARGUMENT

1. The courts below correctly upheld the Commissioner's determination that petitioner's estimates of unpaid losses were excessive.

Petitioner claims (Pet. 12-16) that the Commissioner's disallowance of part of its deduction for unpaid losses was an impermissible change in its accounting method and improper rejection of the method prescribed by the NAIC Annual Report. In this respect, petitioner urges that the decision below conflicts with *United States* v. *Consumer Life Insurance Co.*, 430 U.S. 725 (1977), and *Commissioner* v. *Standard Life and Accident Co.*, 433 U.S. 148 (1977).

But neither *Consumer Life* nor *Standard Life* dealt with a situation that is even remotely comparable. Both of those cases were decided under different statutory systems relating to the taxation of life insurance, rather than casualty insurance, companies. *Consumer Life* dealt with the issue of how certain unearned premium reserves should be allocated between a primary insurer and a reinsurer in determining whether the taxpayer qualified as a life insurance company. *Standard Life* addressed the question of the proper tax treatment for deferred and uncollected life insurance premiums. In those cases, the Court deferred to state regulatory authorities as to the computation of the reserves (*Consumer Life*), and held that the accounting procedures of the NAIC controlled to the exclusion of conventional accrual tax accounting procedures (*Standard Life*). Thus, unlike the instant case,

those decisions did not involve a dispute over the proper amount of a claimed deduction or whether an adjustment constitutes a change in a method of accounting prescribed by the NAIC.

Section 1.832-1(b) of the Regulations requires that in order to deduct estimates of unpaid losses, a casualty insurance company must satisfy the district director that its estimates are "fair and reasonable" estimates of actual unpaid losses. Petitioner failed to meet this test. Where, as here, petitioner failed to establish its entitlement to the deduction claimed (see *New Colonial Co.* v. *Helvering*, 292 U.S. 435, 440 (1934)), but was entitled to some deduction, the Commissioner properly allowed an amount he determined to be a reasonable approximation of the correct deduction. See *Cohan* v. *Commissioner*, 39 F. 2d 540, 543-544 (2d Cir. 1930). Such an allowance does not constitute a change in method of accounting. It simply goes to the correct amount of a claimed deduction.[5]

2. Petitioner further argues (Pet. 16) that the Commissioner's disallowance of a portion of the claimed deduction for unpaid losses disregarded Section 1.832-1(b) of the Regulations. That Regulation requires that a casualty insurance company must establish that its claimed deduction represents a "fair and reasonable" estimate of the total unpaid losses, "based upon the facts in each case and the company's experience with similar cases."

Contrary to petitioner's argument, the Commissioner is not required to reevaluate independently each individual loss before he can disallow any portion of the claimed

[5]If a casualty company consistently overstates its unpaid losses, its taxable income would be consistently understated. Consequently, the company would enjoy substantial tax deferral for as long as the unpaid losses were consistently overstated (Pet. App. A, A12).

deduction. As the court of appeals correctly noted (Pet. App. A, A18), the Regulation places the burden of individual case analysis upon the insurance company. It does not circumscribe the Commissioner's method of verifying the accuracy of the estimate. Indeed, petitioner's own witness Joyce acknowledged (R. 124) that the individual case analysis that petitioner claims the Commissioner should have undertaken was impossible.[6]

3. Finally, petitioner claims (Pet. 19) that Section 1.832-1(b) of the Regulations, which requires that estimates of unpaid losses must be "fair and reasonable" estimates of actual unpaid losses, is invalid.[7] It argues (Pet. 19) that any figure that a company records on its NAIC Annual Statement must be accepted for tax purposes. In support of this contention, petitioner invokes the portion of Section 832(b) which provides that a casualty insurance company's gross income (a component of which is its unpaid losses) shall be computed on the basis of the company's annual statement approved by the

[6]Petitioner's argument ignores the settled rule that it is the taxpayer who must show the authority for his claimed deduction, not the Commissioner who must demonstrate the basis for disallowance of deduction. *New Colonial Co.* v. *Helvering*, 292 U.S. 435, 440 (1934); *Welch* v. *Helvering*, 290 U.S. 111, 115 (1933).

[7]On the same day that Regulations were first issued allowing the deduction of estimated unpaid losses, Com.-Mim. R. A. No. 1366 was also issued. See Rev. Proc. 75-56, 1975-2 Cum. Bull. 596. Com.-Mim. R. A. No. 1366 provided a rule of thumb for auditing agents to use in determining whether estimates of unpaid losses were reasonable. Essentially, Com.-Mim. R. A. No. 1366 provided that the agent was to compare the unpaid losses estimates on each line of insurance business for the five previous years with the actual experience as developed. If the five-year average of estimated losses was more than 115 percent of the five-year average of actual developed losses, the Revenue Agent would presume that current estimates of unpaid losses for those lines were also overstated and that adjustments were in order.

NAIC. In petitioner's view, the statute forbids the Commissioner from challenging unpaid losses as shown on the annual statement, no matter how grossly inflated such claimed losses might be.

But in permitting a casualty insurance company to compute its income in accordance with the NAIC method, Congress did not intend to accord binding tax effect to every figure that a taxpayer might record on its annual statement. Indeed, here the NAIC itself determined that petitioner's estimates of unpaid losses were excessive but did not require a correction (Pet. App. C, A27). The income tax statute does not permit the deduction of erroneously inflated estimates of unpaid losses.

Under Section 7805, the Secretary of the Treasury is authorized to promulgate needed Regulations. These Regulations are to be upheld by the courts if they are found to "implement the congressional mandate in some reasonable manner." *United States* v. *Correll*, 389 U.S. 299, 307 (1967). Here, the requirement of Section 1.832-1(b), that unpaid losses be based on "fair and reasonable" estimates, "implement[s] the congressional mandate" in a reasonable manner and is therefore valid. Since these Regulations or their substantially similar predecessors have been in effect for more than 34 years during which time the statute has been substantially reenacted, the Regulation is deemed to have received congressional approval. See *United States* v. *Correll*, *supra*, 389 U.S. at 305-306; *Commissioner* v. *Noel Estate*, 380 U.S. 678, 682 (1965).[8]

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[8]Petitioner claims (Pet. 21) that insofar as Section 7805 grants the Secretary of the Treasury authority to issue Section 1.832-1(b) of the Regulations, it suffers from a lack of sufficient standards to meet the requirements of due process. But this Court has repeatedly upheld the delegation to the Secretary of the Treasury to promulgate Regulations. See, *e.g.*, *United States* v. *Cartwright*, 411 U.S. 546, 550 (1973); *Bingler* v. *Johnson*, 394 U.S. 741, 750-751 (1969); *United States* v. *Correll*, *supra*, 389 U.S. at 306-307; *Fawcus Machine Co.* v. *United States*, 282 U.S. 375, 378 (1931).

CONCLUSION

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 832. INSURANCE COMPANY TAXABLE INCOME.

(a) *Definition of Taxable Income.*—In the case of an insurance company subject to the tax imposed by section 831, the term "taxable income" means the gross income as defined in subsection (b) (1) less the deductions allowed by subsection (c).

(b) *Definitions.*—In the case of an insurance company subject to the tax imposed by section 831—

(1) *Gross income.*—The term "gross income" means the sum of—

(A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioner,

* * * * *

(5) *Losses incurred.*—The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

(A) To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year.

(B) To the result so obtained, add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year.

* * * * *

(c) *Deductions Allowed.*—In computing the taxable income of an insurance company subject to the tax imposed by section 831, there shall be allowed as deductions:

* * * * *

(4) losses incurred, as defined in subsection (b)(5) of this section;

* * * * *

Treasury Regulations on Income Tax (26 C.F.R.):

§ 1.832-1 *Gross income.*

* * * * *

(b) Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such losses which, in the opinion of the district director are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. The district director may require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."

* * * * *